

SD TR ISO: M 668/2004/June 17-18

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MINUTES
SOUTH DAKOTA INVESTMENT COUNCIL
Radisson Encore Hotel
Sioux Falls, South Dakota
June 17 & 18, 2004

1) Roll Call

The meeting was called to order at 8:00 a.m. by Vice Chair Roy Burr. Council members in attendance were Tom Everist, Bryce Healy, Angeline Lavin, Vern Larson, Larry Ness, Rob Wylie and Roy Burr. Council member Dave Anderson was absent.

Others attending all or part of the meeting included Steve Myers, Matt Clark, Brett Fligge, Tammy Otten, Laurie Riss and Ali Magel (student intern) of the Investment Office; Curt Johnson; Koren Holden of Mellon; Representative Phyllis Heineman; Susan Jahraus of the South Dakota Retirement System; and Doug Hajek.

(Note: For sake of continuity, the following minutes are not necessarily in chronological order. All referenced documents are on file with the Council packet.)

2) Minutes

LARRY NESS MOVED, SECONDED BY BRYCE HEALY, TO APPROVE THE MINUTES OF THE APRIL 27, 2004 INVESTMENT COUNCIL MEETING. MOTION PASSED UNANIMOUSLY.

3) New Council Member

Roy Burr welcomed Curt Johnson to the Council. He noted that Curt was appointed by the Executive Board of the LRC for the five-year term which will commence on July 1, 2004.

4) Investment Update

Tammy Otten presented the investment update. She reviewed a summary of the assets under management noting that as of June 15, 2004, South Dakota Retirement System (SDRS) assets totaled \$5.4 billion and the Cement Plant Retirement Fund totaled \$37 million. The assets of the trust funds as of May 31, 2004 were Dakota Cement Trust \$249.5 million, Education Enhancement Trust \$358.2 million, Health Care Trust \$87.9 million, and School and Public Lands \$145.9 million. The Cash Flow Fund totaled \$791.2 million as of May 31, 2004. Total assets were \$7.113 billion.

In discussing the Cement Plant Retirement Fund (CPRF), Otten stated that, upon the sale of the Cement Plant in March of 2001, the retirement system was frozen going forward. The Cement Plant Commission will be sunseting their organization by the end of 2004 according to Dave Bozeid, the current Chair of the Commission. The responsibilities for managing the benefits of the CPRF will then go on to someone else. She noted that an actuarial valuation will be done as of September 30, 2004, and that it is Dave Bozeid's intent to make certain that this fund is actuarially sound before the Commission sunsets. The Commission is aware that the CPRF is going to be

short, and they are comfortable that there are enough assets remaining to fund any liability issues. The unfunded liability results primarily from the 8% actuarial return not having been made since the sale. Another contributing factor was that the actuarial valuation at the time of sale did not take into consideration that 100% of employees would be retiring under the rule of 85, when eligible, and then continuing to work for the new cement plant owners. She noted that the withdrawals from the CPRF equal about 6% of assets yearly. By comparison, the withdrawals from the SDRS are a little over 1 % annually. The Commission would like to have the assets continue to be managed like the SDRS as much as possible in that they are still long-term liabilities, although not in perpetuity. The average age of members is 45 or 46, and with no new members, the fund is going to age quickly.

Tom Everist asked where the money would go if at some point it was determined that the fund was overfunded. Otten replied that, according to the Constitution, any excess money in the retirement fund would go into Dakota Cement Trust as these funds would be considered as part of the proceeds from the sale of the plant.

Otten reviewed the summary of trust fund values and asset allocation which showed the original values, any additional funds received, the principal values and the fair values as of 5/31/04. The Health Care Trust had a return of 6.23% as of 5/31/04, and the Education Enhancement Trust had a return of 5.61 %. The two portfolios are managed the same except for the tax exempt money required by the bond indenture in the Education Enhancement Trust which is earning less than it could in taxable securities. In both trusts the law allows up to 4% of fair value to be paid out annually as long as principal is not violated. The annual payouts are based on December 31 valuations and will be distributed on July 1. The Health Care Trust will pay out \$3,497,887 and the Education Enhancement Trust will pay out \$14,322,737.

Steve Myers stated that the legislature has been made aware and has been reminded that the indications given to the Investment Council by the policy makers were to invest the money in the trust funds extraordinarily conservatively. The legislature wanted the money invested to assure the 4% and to not worry about maximizing returns until there is enough of a cushion to invest the money more aggressively. He added that over time hopefully these funds can be managed in the same way as SDRS assets.

Otten discussed the Dakota Cement Trust stating that the principal as of 5/31/04 was \$238 million and the fair value totaled \$249.5 million. She noted that \$12 million is required to be paid out annually and that a portion of the principal will be needed to meet the requirement this year. Five percent of market value may be paid out as long principal is not violated. The value of the fund needs to be up to \$251 million before any additional money beyond the \$12 million will be able to be paid out to education.

Otten stated that the fair value of School & Public Lands as of 5/31/04 was \$145.9 million and the rate of return to date was 5.75%.

The fair value summary of SDRS was presented as of June 15, 2004. Otten stated that the total return was 15.69% with most of the gain coming from the last six months of calendar year 2003. She noted that the estimated Russell median return was 15.43% (9 months actual and 2.5 months estimated) and the capital market benchmark 14.29%.

Otten reviewed the asset allocation of 41.7% domestic equity, 21.57% fixed income, 2.7% cash, 18.87% international equity, 6.09% merger and convertible arbitrage, 4.72% real estate and 4.35% private equity. She pointed out the various under and over weights to the capital market benchmark. In describing the fixed income portfolio, Otten stated that 7% of the fixed income portfolio is in higher risk assets with 3% in distressed debt with M.W. Post and 4% in high yield. M.W. Post is up 14.5% fiscal year to date and the internal high yield is matching the benchmark's return of about 9.5%. The remaining 15% is in conventional fixed income securities.

5) SDRS Actuarial Presentation

Koren Holden from Mellon Human Resources presented the SDRS Funded Status to the Council. She noted her presentation will include a review of the SDRS actuarial valuation as of June 30, 2003, the funded status history, funded status comparisons, cushion and funded ratio projections as of June 30, 2004, and the assumption review process.

In reviewing the SDRS funded status as of June 30, 2003, Holden stated that the actuarial accrued liability totaled \$4.819 billion. The actuarial value, or smoothed value, of assets was \$4.686 billion with a market value of about \$4.784 billion, which resulted in a cushion of about \$98 million. The funded ratio based on the actuarial value was 97% and 99% based on the market value of assets. Holden stated that comparing SDRS to other statewide systems, SDRS is one of the best funded systems in the nation. As an actuary, she is very comfortable with a funded ratio of 99%.

Holden reviewed the current economic assumptions and methods. The investment return assumption is an 8% return which compares to the national and regional average at 8.1 %. The assumption for salary increases is 6% compared to the national average of 5.6%, and the assumption for inflation is 4.5% compared to the national average of 4.2% and regional at 4.0%. SDRS uses an "entry age normal" actuarial cost method which is widely accepted as standard and considered to have enough conservatism built into it.

Holden discussed the SDRS methodology for managing experience variations. The use of a reserve for funding of long-term benefit goals is a method to credit gains or charge losses. By using the reserve, volatility in actuarial measures is avoided. The reserve pre-funds benefit improvements and provides protection against future unfavorable experience. In discussing the process, Holden stated that asset gains and liability gains/losses that occur are allocated to the reserve over a five-year period. Any asset losses, any investment return below the 8% that is required long term, are allocated immediately to the reserve. Before the Board of Trustees spends any money from the reserve, they consider the amounts currently available, the amounts in the queue, the investment performance and outlook, the ratio of market value of assets to actuarial value of assets and reserve, and the downside risk.

Holden reviewed an exhibit showing the history of the reserve for funding of long-term benefit goals. The report showed the gains spread over five years and the losses that were taken in the last three years. The cumulative balance on June 30, 2003 was a negative 57 million resulting a reserve balance of zero. The reserve fund has achieved one of its goals which was to cushion the

blow against bad economic times. Myers pointed out the approximately \$800 million in benefit improvements made during the good times from 1997 through 2000. There have been no benefit improvements in the last three years.

Holden reviewed the funded status history. Since inception in 1973, the fund has gone from 40% funded to the highest funded ratio in 1998 and 1999 of 132% to the current 99% in 2003. She compared the SDRS funded ratios to the national survey average and regional survey average from a Wilshire study. The June 30, 2003 market value funded ratio of 99% for SDRS compared to the national average of 75% and the regional average of 81 %. The actuarial value funded ratio for SDRS was 97% compared to national at 85% and regional at 92%. The historical market value and actuarial value funded ratios were reviewed for the individual years ended June 30, 2000 through June 30, 2003. In all instances, the SDRS funded ratios were higher than the national averages. Holden stated that these funded ratios speak well to the conservatism that SDRS believes in and practices.

Holden reviewed cushion and funded ratio projections as of June 30, 2004, using different investment returns of 6, 8, 10, 12 and 14%. The market value funded ratio would be 97% with a 6% return and 105% with a 14% return. She noted that the accumulative balance in the reserve currently is \$-57 million. With a 14% investment return, the reserve would be about \$50 million, and in the pipeline there would be about \$250 million. She reviewed the annual investment returns that would be required over five and ten years with the various investment returns. As an example, with a 14% return, the fund could withstand five years of 6.3% returns or ten years of 7.2% returns and still be actuarially balanced.

Curt Johnson referred to Myers' caution about going forward with the COLA. He asked whether that would be hard thing for people to understand with funded ratios of over 100%. Myers stated that the better the performance, the weaker the argument seems to become. It is actually the opposite of that because if one assumes that performance comes from assets becoming more richly valued, then it means the expected return going forward is even less. Myers added that the lower expected returns that the actuary and the Investment Office have agreed upon at a 7.5% level, represents a 50/50 percent chance of accomplishment. He asked if one should fund a system on the basis of having a 50% chance of being funded out 20 or 30 years from now. In his opinion, the answer is no.

In reviewing objectives and methodology of the assumption review process, Holden stated that a prudent and methodical review will result in selection of actuarial assumptions that are realistic and explicit and are appropriately conservative given the fiduciary responsibility of SDRS. In this process it is typical to use five and ten year cycles. She stated that they reviewed each individual assumption, both economic and demographic. They compared actual plan experience with current assumptions. In the process they requested input from the Investment Office, an investment consultant out of Mellon's Denver office and a forecasting and planning specialist out of Mellon's New York office. They used professional judgment to estimate possible future outcomes based on past experience and trends and expert data and input. Based on their analysis and professional judgment, they recommended changes/adjustments to current assumptions. Holden noted that all the demographic adjustments they recommended were adopted by the SDRS board at their April, 2004 meeting. There is still ongoing discussion regarding economic discussions,

including inflation and investment return, salary scale, investment return credited on employer/member contributions and the provision for expenses.

Holden discussed a summary of different economic assumption sets. She reviewed nine scenarios using varying assumptions for inflation, investment return, average rate of pay increase and return on contributions. Scenario 7 was highlighted which assumes inflation of 3.5% annual real rate of return of 4%, annual nominal rate of return of 7.5%, annual real pay increases of 1.5%, annual nominal pay increases of 5%, real return on contributions of .5% and nominal return on contributions of 4%. This compares to the current assumptions of 4.5% for inflation, 3.5% for real rate of return, 8% for nominal rate of return, 1.5% for real average wage increases, 6% for nominal average pay increases, 1.5% for annual real return on contributions and 6% for nominal return on contributions.

Myers commented on the five year horizon investment return assumption. He stated that in looking at a short period of time, five years, for an expected return when it is the long-term return that overwhelms the cost of the system seems to be counter-productive. He added that the Investment Office has always felt that it is impossible to forecast short time periods of return. In looking at the current assumptions that were recommended to the SDRS board (scenario 7), it is important to realize that there are some fairly aggressive aspects of that even though it is a lower overall return at 7.5%.

Holden stated that from an actuarial point of view, they do put more weight on historical capital market long-term returns. They feel more comfortable with the 8%, however, they feel it is important not to ignore the current economic feel for lowering expectations. They are open to compromise because they feel the need for everyone's comfort level and the level of conservatism.

Everist noted that from current assumptions, scenario 7 is increasing the real rate of return and decreasing the assumption on salary increases, which is less conservative. As a result, scenario 7 is actually more aggressive than what is used currently.

Matt Clark responded that the spread between the investment return compared to the COLA would be narrowing by moving to 7.5%, and that is a conservative move. The net of all of that does cause the liability to rise, which makes it more conservative.

Rob Wylie stated that there are so many factors to consider. There is also the legal factor of how and to whom an established benefit can be changed. Myers stated that if that interpretation carries the day, that a benefit granted is in granite and cannot be changed, then the recommendation would be to at least reduce the cost going forward by changing it to an indexed level with a cap for newer people.

In response to Everist's question on why the 3.1 % COLA came to be, Myers responded that it came about as a compromise in the early 1980's as pressure was mounting to include a healthcare benefit as part of the retirement system's benefit structure. He stated that at the time he made the argument that a good solid COLA, albeit with a cap, would help offset rising medical costs without the unpredictability associated with volatile and significant healthcare cost increases.

Holden reviewed their preliminary projection of SDRS funded status as of June 30, 2004, after possible actuarial assumption changes (scenario 7) and 2004 experience. It showed a cushion of \$130 million on June 30, 2004 with the cumulative balance in the reserve of \$-2 million and \$4 million in the pipeline. With a funding period of 20 years, the actuarial value would be 97% and market value would be 99%.

In summary, Holden stated that: (1) SDRS continues to be one of the very best funded state-wide systems nationally and the best in the region. (2) Over \$300 million of unanticipated costs removed from System due to 2004 legislation recommended by SDRS Board of Trustees. (3) The reserve methodology has protected the System in the 2000 to 2003 period. (4) The cushion should be increased significantly at June 30, 2004 due to FY 2004 investment results. (5) The cushion at June 30, 2004, will help maintain SDRS funded status for a time if 8% investment return assumption is not realized. (6) The SDRS demographic assumptions have delivered small gains and losses during the five-year study period with a reduced cost going forward of \$120 million. (7) The SDRS Board of Trustees is reviewing the current long-term expected rate of return of 8%.

Larry Ness asked if there was anything in the future that would change the demographics. Wylie responded that very good updates were done in the demographics area and were implemented in the recent changes made in April. He added that there were so many pieces to it resulting in many plusses and minuses throughout and ended up \$120 million to the good. Holden added that every year a detailed gain/loss analysis is done, and every five years it is looked at in more of a longterm perspective.

6) Asset Allocation

South Dakota Retirement System & Cement Plant Retirement Fund

Matt Clark reviewed the normal asset allocation and minimum and maximum allocations for each category. The capital market benchmark allocation for fiscal years 1996 through 2004 were presented. He discussed the reasons why the recommended benchmark allocation for a year might differ from the normal asset allocation. These included extraordinary events such as the very high market valuations that led to lowering the equity weighting in the benchmark from 7/1/99 to 6/30/01 and asset class unavailability such as for merger arbitrage at the current time where the invested level is very low due to absence of mergers.

Clark then reviewed the asset allocation modeling process. He described the calculation of expected returns for stocks, bonds and cash. The equity expected return is the normal dividend yield plus the normal growth rate. The bond and cash expected returns are the yields of the 30 year Treasury bond and 3 month Treasury bills. Equity risk premiums are calculated by comparing the equity expected return to bonds, cash and inflation. The risk premiums are compared to target risk premiums which are based on historical averages. The excess risk premiums versus bonds, cash and inflation are combined to get the overall equity excess risk premium. A positive overall score indicates that equities provide an above target risk premium and are attractive.

Clark discussed the importance of using normalized earnings and growth rates to smooth out cyclical fluctuations and to get a better measure of longer term underlying growth. He showed

going back to 1960 normal earnings versus actual and normal growth versus a 10 year rolling growth. He discussed the impact on reported earnings of the high level of goodwill impairment write-downs in 2001 and 2002. He showed the expected returns, risk premiums and excess risk premiums going back to 1960.

Clark compared normal earnings for 2004 to S&P500 operating earnings for 2000 (a peak year) and 2001 (trough year) and consensus estimates for 2004 and 2005. He described several adjustments to operating earnings to better reflect economic profits. The adjustments related to write-offs, pension expense, and options compensation expense. The average of the peak and trough years after adjustments is \$50, a little below the adjusted consensus operating earnings for 2004 of \$53 and normal earnings of \$51 (including the added .50 cents per quarter). He said that normal earnings are intended to represent average earnings power, not peak or trough levels. He said that we remained comfortable with the appropriateness of the earnings normalization process.

Everist asked what would cause us to remove the .50 cent adjustment to normal earnings. Clark said that over time the restructuring benefits and other issues that triggered the need for the adjustment would become a meaningful part of the 1952 to now historical period of time from which we derive normal earnings. As that happens over the next 5 to 10 years, we should be able to reduce or eliminate the adjustment.

Clark showed the model scores quarterly going back to 1994. He discussed the changes in the equity weighting in the benchmark from 42% down to 36% for FY2000 when valuations were high (and the model score negative) and the change back to 40% for FY2002 at lower valuations and a positive model score. He reviewed the current equity model score attractiveness of a positive +89 basis points. He showed the sensitivity to different levels of inflation, growth rates, and Treasury bill yields. The model score becomes negative at a 3% inflation rate and a lower growth rate (to be consistent with a 3% inflation assumption which is a little below the long term historical average inflation rate).

Everist asked why the domestic equity allocation had wider swings in the 1980's than the range of movement in recent years. Clark said there were several reasons: (1) Back then we mostly had just U.S. stocks, bonds, and cash. Now use of other asset categories ties up a substantial portion of the assets leaving less for domestic stocks, bonds, and cash which dampens the size of moves in those categories as a percentage of the total. (2) Utility functions shift over time. The performance of the asset allocation process has been episodic with the tendency to lose by a little most of the time and occasionally add large amounts of value. Long losing periods tend to diminish enthusiasm for aggressive utilization of the program, even though the best periods tend to follow. (3) The make-up of Council members changes over time, which alters attitudes toward taking on deviance risk. He indicated we needed to carefully judge the amount of under-performance that would be tolerated without the Council losing patience and pulling the plug on a program. He said he experienced in the early 90's the Council losing patience with the under-performance in the equity portfolios resulting from a large over-weight in the financial services stocks as they were undergoing distress. He said the under-performance in the portfolio managed by the other internal domestic equity manager at the time led to the decision to cut back on exposure to the sector. He said he had to cut back on his portfolio's exposure to the sector, despite strongly expressed desires to increase the weighting. He said the sector subsequently outperformed substantially. He said being able to

maintain and even increase the holdings of undervalued companies when they are cheapest is crucial to being able to outperform using a value oriented investment strategy.

Myers said this is an issue we feel strongly about because we have seen this type of pressure historically. He said on the whole the board has been supportive and has usually not exercised the alternative. He said, however, at the critical times when best values have existed, there have from time to time been one or two Council members that have put portfolio managers through psychological hell. He said it is the single biggest thing that can get in the way of a portfolio manager taking advantage of the best opportunities.

Clark said he believes one of the reasons that we have been successful over the long term is that during most of the tough periods we collectively have reasonably stuck to our disciplines.

Clark then discussed the regression to the mean table which suggests very different answers depending on which period is used to determine how much real return to expect from equities in the future if there is a tendency toward reversion to a long term mean return. The periods that were discussed as making some sense to focus on back on 6/30/2000 suggested a long term future real equity return of no more than 4% to 5%. Due to market declines since then, the expectations have increased to 4.5% to 6.0%.

Ness asked how frequently we react to changes in the valuation model. Clark said the model is run every day and more frequently if needed. He said we meet at least quarterly to discuss and generally establish valuation trigger points where we would expect to change the allocation. An important consideration is our confidence in the valuation inputs. We focus more intently and try to update thoughts on the inputs as triggers are approached. Myers discussed some instances when we needed to act quickly including October 1987 and following September 11, 2001.

Clark discussed an exhibit of the expected equity return views of several leading consultants and respected investment managers such as Warren Buffett. Most of the views were supportive of the internal 7.6% long term expected return.

Clark reviewed the mean variance asset allocation analysis which shows the long term mean expected return and expected standard deviation. The incremental return and standard deviation impact of use of each asset class relative to a 60:40 mix was shown. The higher expected return results from use of asset categories that have a higher expected return than a 60:40 stock/bond mix. The standard deviation is not expected to be higher than a 60:40 mix due to diversification enhancement resulting from use of asset classes that are only partially correlated to each other and against domestic equities.

Angeline Lavin asked what data we use to derive the correlation matrix. Clark said that for more conventional asset categories we calculate the correlations primarily using annual returns since 1970 with some subjective adjustments. We use shorter periods where less data is available and in some cases we must rely on analogy or our sense of the relationship between the underlying risk exposures of the asset categories. Clark said that he has previously discussed the individual correlations with a previous Council member and would be happy to explain the rationale behind each if anyone desires.

Clark presented the recommended FY2005 capital market benchmark for SDRS. He discussed the combining of domestic and international equity to form global equity. He discussed the recommended increases in global equity from 56% to 57% and high yield/distressed from 6% to 7%. He discussed the recommended decrease in convertible arbitrage weighting from 4% down to 3% and real estate from 7% down to 6%. The changes relate to the departure of the convertible arbitrage portfolio manager and a reduction in attractive opportunities in real estate.

LARRY NESS MOVED, SECONDED BY ROB WYLIE, TO APPROVE THE INVESTMENT POLICY FOR THE SOUTH DAKOTA RETIREMENT SYSTEM FOR FISCAL YEAR 2005 WITH AN ASSET ALLOCATION POLICY BENCHMARK OF 57% GLOBAL EQUITY, 2% MERGER ARBITRAGE, 3% CONVERTIBLE ARBITRAGE, 19% FIXED INCOME, 7% HIGH YIELD/DISTRESSED, 6% REAL ESTATE, 4% PRIVATE EQUITY, 1 TIPS/COMMODITIES AND 1 % CASH. MOTION PASSED UNANIMOUSLY.

Clark presented the recommended FY2005 capital market benchmark for the Cement Plant Retirement Fund. He discussed the combining of domestic and international equity to form global equity. He discussed the recommended increases in global equity from 56% to 57%, investment grade fixed income from 20% to 21 % and high yield/distressed from 6% to 7%. He discussed the recommended decrease of real estate from 7% down to 6% and cash from 4% to 2%. The changes relate to a reduction in attractive opportunities in real estate and an anticipated cash infusion following an actuarial evaluation this upcoming fall. It is not currently practicable due to the size of the CPRF for the fund to participate in the internally managed convertible arbitrage program.

LARRY NESS MOVED, SECONDED BY VERN LARSON, TO APPROVE THE INVESTMENT POLICY FOR THE CEMENT PLANT RETIREMENT FUND FOR FISCAL YEAR 2005 WITH AN ASSET ALLOCATION POLICY BENCHMARK OF 57% GLOBAL EQUITY, 2% MERGER ARBITRAGE, 21% FIXED INCOME, 7% HIGH YIELD/DISTRESSED, 6% REAL ESTATE, 4% PRIVATE EQUITY, 1% TIPS/COMMODITIES AND 2% CASH. MOTION PASSED UNANIMOUSLY.

Dakota Cement Trust

Otten described the allowed investments for the Dakota Cement Trust. The Constitution allows "stocks, bonds, mutual funds and other financial instruments as provided by law". Accompanying statutes (SDCL 5-17) apply the prudent man standard. She indicated the beginning value of the fund as of April 18, 2001 (the date the constitutional amendment became effective) was \$238 million. Four annual payments of \$12 million have been made from the fund to the General Fund beginning in June of 2001. The Constitution requires a \$12 million payment each year (usually in June). The payments will be made even if they violate the original \$238 million principal. An additional payout for educational purposes will be available if 5% of the market value of the fund exceeds \$12 million as of 6/30 each year and does not violate the original principal of \$238 million. After the first five years, the 5% will be applied to the 16-quarter average market value per the Constitution.

Otten described the proposed investment policy for FY 2005 that is intended to be conservative with an income orientation. The proposed allocations were 20% domestic equity, 5% international equity, 15% REITs (Real Estate Investment Trusts), 10% high yield bonds, 19% investment grade corporate bonds, 27% mortgage backed securities, and 4% agency securities. This differs from FY 04 by adding 5% to international equities and decreasing 5% from fixed income securities. As the portfolio increases in assets, the investment policy will continue to increase the equity allocation. The equity holdings will emphasize yield to generate income for the annual payout. Income is removed from the underlying portfolios each month and placed in an income account to meet the annual distribution. The expected income yield of 4.4% will generate expected dividend and interest income of \$10.4 million annually. The FY 05 expected income rate is higher due to the higher coupons of bonds already in the portfolio. A table was reviewed with expected capital gains and losses for three scenarios: up one, down one and down two standard deviations based on the expected volatility for each category.

Myers reminded the Council that, as discussed earlier in the investment update, legislators need to be aware that the \$12 million will not be met by the income off of this portfolio this year and that in order to distribute this amount each year, the fund needs capital appreciation.

Burr asked if the international portion of the asset allocation for the trust was now a global equity investment. Myers stated the international portion is only ADR's in the trusts. These trusts are very income oriented by policy. If the assets were invested in the same way as SDRS, the international portion would be global.

Everist asked how much the asset allocation varies from the minimums and maximums. Otten responded that we don't vary much from the approved asset allocation.

Everist stated that it is necessary to get past the behavior issue and adjust asset allocation to try and increase the value of the fund. He added that it was important the legislature understood that approach.

Representative Phyllis Heineman agreed that the Executive Board should be kept educated about the trusts and the investment policies geared to income orientation perhaps being sub-optimal.

VERN LARSON MOVED, SECONDED BY ANGELINE LAVIN, TO APPROVE THE INVESTMENT POLICY FOR THE DAKOTA CEMENT TRUST FOR FISCAL YEAR 2005 WITH AN ASSET ALLOCATION POLICY BENCHMARK OF 20% DOMESTIC EQUITY, 5% INTERNATIONAL EQUITY, 15% REITS, 50% FIXED INCOME, AND 10% HIGH YIELD. MOTION PASSED UNANIMOUSLY.

Health Care Trust & Education Enhancement Trust

Otten reviewed the allowed investments for the two trust funds. The Constitution created the funds in April of 2001 and allows investment in "stocks, bonds, mutual funds and other financial instruments as provided by law". During FY 02, the funds were part of the Cash Flow Fund. Effective FY 03, legislation applied the prudent man standard to the investments and established the annual payout of 4% of fair value without violating principal. With the codified laws in place,

separate portfolios were established. In FY 04, the distribution valuation date was changed from June 30, 2004 to December 31, 2003 and each December 31 thereafter. Beginning with the FY 07 distribution, the 4% will be applied to the 4 years average December 31 market value. The July 1, 2004 distribution to the General fund from the Health Care Trust will be \$3,497,887.68 and from the Education Enhancement Trust \$14,322,737.37. This money was appropriated by the Legislature for the FY 05 budget year.

The May 31, 2004 balance in the Health Care Trust fair value is \$88 million and \$358 million in the Education Enhancement Trust. The two funds' principal can be accessed by the legislature with a three-fourths vote. The Education Enhancement Trust holds tax-exempt fixed income securities in a portfolio managed by PIMCO.

The recommended FY 05 asset allocation for the Health Care Trust is 24% domestic equity, 6% international equity (ADRs), 10% REITS, 10% high yield corporate bonds, 18% investment grade bonds, 18% mortgage backed securities, 4% US treasuries and agencies, and 10% TIPS (Treasury Inflation Protected Securities). The FY 05 recommendation differs from FY 04 with 1 less domestic equity, 6% more international equity, and 5% less fixed income. The equity portfolio will tilt toward income and lower portfolio volatility and the bond portion will tilt toward lower duration to reduce volatility. The recommendation has a long-term expected return of 5.9% and volatility of 7.7%. A table was reviewed with expected capital gains and losses for three scenarios: up one, down one and down two standard deviations based on the expected volatility for each category.

Bryce Healy asked if there was a phase-in timeframe for this portfolio's asset allocation. Otten responded that the Health Care and Education Enhancement trusts are not like the School and Public Lands fund where the equity exposure was increased 10% each year for five years.

Myers stated that his recommendation would be that when the four-year averaging kicks in a couple years from now, the decision should be made to move the asset allocation to a policy more similar to the SDRS.

ROB WYLIE MOVED, SECONDED BY BRYCE HEALY, TO APPROVE THE INVESTMENT POLICY FOR THE HEALTH CARE TRUST FOR FISCAL YEAR 2005 WITH AN ASSET ALLOCATION POLICY OF 24% DOMESTIC EQUITY, 6% INTERNATIONAL EQUITY, 10% REITS, 40% FIXED INCOME, 10% HIGH YIELD, AND 10% TIPS. MOTION PASSED UNANIMOUSLY.

The recommended FY 05 asset allocation for the Education Enhancement Trust, which includes tax exempt fixed income securities as required by the tobacco bond asset-backed securitization, is 24% domestic equity, 6% international equity (ADRs), 10% REITS, 10% high yield corporate bonds, 4% investment grade bonds, 3% mortgage backed securities, 33% Taxexempt bonds, and 10% TIPS. The recommendation differs from FY 04 with 1 % less domestic equity, 6% more international equity, 3% less fixed income, 2% less tax-exempt. The equity portion will tilt toward income and the bond portion toward lower duration to reduce volatility. The recommendation has an expected long-term return of 5.4% (less than the HCT due to the taxexempt allocation) and expected volatility of 7.7%. A table was reviewed with expected capital

gains and losses for three scenarios: up one, down one and down two standard deviations based on the expected volatility for each category.

During FY 04, \$2,421,214.83 was de-allocated (removed) from the tax-exempt portfolio because the value of the tax-exempt investments plus the liquid reserve held by the trustee exceeded the value of the tax-exempt bonds outstanding. This contributed to the lowering of the allocation to the tax-exempt category.

ANGELINE LAVIN MOVED, SECONDED BY LARRY NESS, TO APPROVE THE INVESTMENT POLICY FOR THE EDUCATION ENHANCEMENT TRUST FOR FISCAL YEAR 2005 WITH AN ASSET ALLOCATION POLICY BENCHMARK OF 24% DOMESTIC EQUITY, 6% INTERNATIONAL EQUITY, 10% REITS, 7% FIXED INCOME, 33% TAXEXEMPT FIXED INCOME, 10% HIGH YIELD, AND 10% TIPS. MOTION PASSED UNANIMOUSLY.

School & Public Lands

Otten discussed the allowed investments for the School & Public Lands fund. The fund was historically restricted to government guaranteed fixed income securities. The Constitution was changed in November of 2000 to broaden the investments to "stocks, bonds, mutual funds and other financial instruments as provided by law". The Constitution requires that all income be paid out to the schools after the principal of the fund is made whole from the effects of inflation. Inflation as measured by the CPI is applied to the principal of the fund each June 30. The CPI holdback is funded from net realized capital gains (per SDCL 5-10-18.3(4)) and if insufficient, from received income. It is anticipated that the CPI adjustment for FY 04 will be approximately \$4 million.

Otten stated that FY 05 will complete the 5-year phase-in process of moving the portfolio asset allocation from 100% fixed income to 50/50 stocks/bonds to balance growth and income. The stock allocation is 40% domestic and 10% international to enhance diversification. The fixed income allocation is 40% high grade and 10% high yield securities to enhance income. The FY 05 asset allocation differs from the FY 04 allocation by increasing stocks by 10% in international and decreasing marketable fixed income by 5% and private fixed income by 5%.

The 5-year asset allocation phase-in dampened the initial drop in the annual income payout to schools. The payout has been adversely affected by the inflation adjusted hold-back as the CPI has risen from 1.1 % in 2002 to 2.1 % in 2003 and 3.1 % in 2004. The long-term expected yield is about 4.1 % and the long-term expected growth is 2.55% that approximates the long term expected inflation. The 5-year policy implementation highlights were reviewed.

Myers reminded the Council that as the changes were taking place with the S&PL fund, everybody was saying that many years from now, the school districts will be pleased. In the meantime, the Council is going to take some heat. The Council went on record saying that the hit is for the good of the fund and that fingers should not be pointed at the S&PL Commissioner.

Representative Heineman asked how long it will take to get back to better payouts. Myers responded that it depends on the level of inflation, the amount of realized gains and the level of interest rates. He added that it could stay at this level for several years.

Myers asked Healy if S&PL is seeing anybody calling on good SBA's. Healy responded that they have quit doing individual SBA's because fixed income was providing a better return. He added that if the associated school boards asked for help in financing a building, they would do that.

A review of the impact of alternative asset allocation policies on the expected level of income and long-term growth for an all bonds, 50/50 conservative and 40/10/40/10 normal policy was presented. The higher yield of the all bonds offset by the inflation adjustment results in 1.4% less net yield than the normal policy is expected to produce. A mean variance analysis of the proposed policy was reviewed. The expected return and standard deviation was shown for the proposed policy as well as more and less conservative alternatives based on expected returns and standard deviations for each asset class and the correlation among them.

BRYCE HEALY MOVED, SECONDED BY TOM EVERIST, TO APPROVE THE INVESTMENT POLICY FOR THE SCHOOL AND PUBLIC LANDS FUND FOR FISCAL YEAR 2005 WITH AN ASSET ALLOCATION POLICY BENCHMARK OF 40% DOMESTIC EQUITY, 10% INTERNATIONAL EQUITY, 35% MARKETABLE FIXED INCOME, 5% PRIVATE FIXED INCOME, AND 10% HIGH YIELD. MOTION PASSED UNANIMOUSLY.

Cash Flow Fund

Otten provided an overview of the Cash Flow Fund. The allowed investments are specified in SDCL 4-5-26 legal list. The fund can only invest in investment grade fixed income securities. The annual payout is outlined in SDCL 4-5-30 and 4-5-30.1. The fund is divided into a short-term money market fund for daily needs of the state, the I -year CD program with state financial institutions, and the larger duration portfolio. The duration portfolio's asset allocation is 60% investment grade corporate bonds, 27% treasury/agency and 13% money market funds. The maximum maturity of any one security is 5 years and position size is limited based on credit rating of the bonds. The total portfolio maximum duration is 2.88 years because of its short-term nature. For FY 04, the fund is projecting a payout of 3.0%. Based on current holdings and interest rates, the FY 05 payout projection is 2.0%. The long-term expected return of the fund is 3.6% with a volatility of 1.7%.

This year the law on the proration of income was changed to allow the general fund to receive 90% of the estimated amount due in June of the current fiscal year instead of waiting until the next fiscal year.

Ness asked if that is expected to happen every year going forward. Otten responded that she expects it will happen every year until the law is changed.

Healy asked the reason for 90%. Otten responded that it was the number selected by the legislature. The original bill had 80% but it was moved to 90% with the law stating that a debt or credit adjustment would be made in the next fiscal year.

7) Global Equity

Brett Fligge contrasted past domestic equity management with the going forward global equity plan. The key changes include (1) A new coordinating team of senior people to manage the core portfolio; (2) Additional equity portfolio managers/analysts organized into teams; (3) A new more in-depth corporate profitability modeling process; (4) More frequent and consistent schedule of meetings and interactions of the coordinating team with the sector teams; (5) Greater concentration of portfolios into best ideas; (6) Domestic and international combined into global; and (7) Increase in weighting of the core portfolio to 60% of the internally managed equities.

Fligge contrasted the current concentration of the domestic portfolio based on the 10 and 25 largest positions with that of the international portfolio. The international portfolio has been significantly more concentrated into the best ideas. He indicated that the concentration of the global equity portfolios would lean toward what international has been.

Fligge reviewed the equity valuation process starting with fundamental background research. Normal earnings and the normal growth rate are estimated then used along with an assigned risk rating and discount rate to calculate a present value. The stock price is compared to the present value to get Price/Value.

Everest asked whether staff plans to visit the companies in which they will invest. Fligge said that it is the intention that the global team members have more interaction with managements and analysts. He indicated that it would likely be through telephone calls and at conferences.

Ness commented that Sarbanes Oxley requirements should improve the quality of information in corporate filings and written research. Fligge agreed. Myers said that attendance of very high quality industry focused conferences is the most efficient way to interact with managements. He added that the investment staff needs to know that it is part of their responsibilities to attend these productive conferences.

Fligge reviewed the several SDRS component portfolios comprising the global equity effort. The global core portfolio will begin with \$1.85 billion. The universe will be primarily the S&P global 1200. The benchmark will be the S&P global 1200 weighted 2/3 and the S&P 500 weighted 1/3 (to increase the weighting of the U.S. component). Global core will be managed by the coordinating team (Steve Myers, Matt Clark, Brett Fligge). The sector portion will be divided into five sector portfolios. The aggregate will begin with \$1.25 billion. The universes will consist of the companies in the S&P global 1200 within industries assigned to each team. He noted that outside managers are used (currently totaling \$140 million) to provide selected niche exposures and for educational purposes. The total aggregates to \$3.25 billion for global equity. The benchmark for the total is the MSCI All-World weighted 2/3 and the MSCI All-World U.S. Component weighted 1/3.

Fligge reviewed the portfolio diversification rules for the global core and sector portfolios which are minimum and maximum permissible weightings for each country, sector, and industry based on the benchmark weighting of each. There are also maximum weightings at the individual stock level based on the weighting of the stock in the benchmark. The rules are intended to be

broad enough to allow and encourage portfolio managers to take meaningful deviations from the benchmark to add value, while providing appropriate diversification among countries, industries, and stocks with consideration for how the portfolios combine to produce the aggregate global equity portfolio level. He provided several examples to illustrate application of the rules using the U.S. and Japan as country examples, health care as an example of an industry and a couple of company examples all for the global core and similar examples for a global sector.

Fligge noted that the change to a new accounting system, PORTIA, that has global capabilities was proceeding as planned. He said that custodial bank securities movement preparations had been made. He said stock trading would be coordinated by experienced staff and that currency trading would be carried out as it had been for international.

Otten described the installation and implementation process of PORTIA, the new global investment accounting software. She said that the Bureau of Information and Telecommunications (BIT) agreed to install the software on our server in Pierre and maintain it. She added that BIT has done a very good job and has been great to work with on this project. She is very pleased with how everything is proceeding. Investment Accounting staff has been involved in training and will be ready to go with the new system on July 1.

Everist commented on the accounting software being installed on the server in Pierre which is a controlled environment. He stated that using Citrix was adding a level of security by being able to control who is on line and when. Otten stated that BIT has all of the firewalls, security, backups, and trained people to make it a very secure system. She added that there is another level of security with PORTIA because there is a very strong security system built in. All of these security measures complement the Investment Office's internal control.

8) Benchmarks & Incentive Plan Changes

The global equity benchmark for the capital market benchmark was discussed.

TOM EVERIST MOVED, SECONDED BY BRYCE HEALY, TO USE THE MSCI ALL COUNTRY WORLD INDEX WEIGHTED 2/3 AND U.S. COMPONENT WEIGHTED 1/3 FOR THE TOTAL GLOBAL EQUITY BENCHMARK. MOTION PASSED UNANIMOUSLY.

Everist asked how this benchmark compares to the previous benchmark used for international. Clark responded that MSCI All Country Ex U.S. was currently being used for international. The change for global equities is to include the U.S. component of the MSCI All Country index which includes around 460 companies and is similar to the S&P 500. Myers added that there is a larger cap bias in the S&P 500 and the U.S. component of the MSCI All Country compared to the previous domestic benchmark, the Russell 1000. We can tactically add exposure to mid and/or small cap stocks if the valuations differences are meaningfully more attractive at any given point.

In discussing incentive plan changes, Everist noted that the Compensation Committee had met by conference call and reviewed all of the recommendations for incentive plans after the transition. The Committee discussed the methodology of the incentives with the change to the

global equity approach. He confirmed that the Council had received two memorandums dated May 24, 2004 and June 4, 2004 that describe in detail the proposed changes to the incentive compensation plan for individuals impacted by the change to global equity management.

Clark described the new incentive program for the sector portfolio managers, including Scott Hess, Sherry Nelson, Steve Schultz, Melissa Hansen-Woidyla and Darci Haug. These incentives will be based 40% on the performance of their individual sector portfolio versus their sector benchmark. The global sector benchmark is the S&P global 1200 sector benchmark portfolio weighted 2/3 plus the U.S. component of the S&P global 1200 sector benchmark portfolio (S&P 500 sector portfolio) weighted 1/3. The remaining 60% will be based on the performance of the global core portfolio versus its benchmark based on the S&P Global 1200. The global core benchmark is the S&P global 1200 weighted 2/3 plus the U.S. component of the S&P global 1200 (S&P 500) weighted 1/3. One-third of the incentive relates to the most recent one-year time period and two-thirds to the average of the most recent four years of performance versus the benchmark.

Clark reviewed the incentive changes for the other people affected by the transition. He noted that Candi Currier's incentive will be based 50% on merger arbitrage and 50% on global equity. The incentives for Matt Clark and Brett Fligge will change (except for the one-third for Brett Fligge relating to merger arbitrage) to be based on the total global equity versus the total global equity benchmark (MSCI All Country weighted 2/3 plus the U.S. component of the MSCI All Country weighted 1/3). One-third of the incentive will continue to be based on the most recent one-year performance and the other two-thirds will continue to be based on the average performance versus benchmark for the most recent four years.

Everist commented on the change of 60% based on the core and 40% on individual sector as opposed to the previous 80% on individual sectors. He felt this was the biggest real change that could affect motivation and emphasis and how they work together as a team.

Lavin referred to the added degree of difficulty in the previous concentrated portfolio incentive schedule and asked why it was not included in the new incentive schedules. Myers responded it was decided that beating the benchmark by 300 basis points was tough enough and so the penalty was removed.

LARRY NESS MOVED, SECONDED BY VERN LARSON, TO APPROVE THE CHANGES IN INCENTIVES AND BENCHMARKS AS OUTLINED IN THE MEMORANDUMS FROM STEVE MYERS AND MATT CLARK DATED MAY 24, 2004 AND JUNE 4, 2004 (ATTACHED), SUCH CHANGES TO AFFECT EMPLOYEES MATT CLARK, BRETT FLIGGE, MELISSA HANSEN-WOIDYLA, DARCI HAUG, SCOTT HESS, SHERRY NELSON, STEVE SCHULTZ AND CANDI CURRIER AND ARE EFFECTIVE FOR THE PERFORMANCE PERIOD BEGINNING JULY 1, 2004 FOR FISCAL YEAR 2005 WITH THE EARNED INCENTIVES TO BE PAID BY FY 2006. MOTION PASSED UNANIMOUSLY.

The Investment Council recessed at 4:30 p.m. and reconvened at 8 a.m. on June 18, 2004.

9) Executive Session

BRYCE HEALY MOVED, SECONDED BY LARRY NESS, TO GO INTO EXECUTIVE SESSION TO DISCUSS PERSONNEL ISSUES. MOTION PASSED UNANIMOUSLY.

General session reconvened at 9:25 a.m.

FY 2006 Personnel Budget Request

LARRY NESS MOVED, SECONDED BY ANGELINE LAVIN, TO APPROVE THE FISCAL YEAR 2006 PERSONNEL BUDGET AS PRESENTED, WITH FUTURE BENEFIT ADJUSTMENTS MADE IF NEEDED ACCORDING TO THE BUREAU OF FINANCE AND MANAGEMENT. MOTION PASSED UNANIMOUSLY.

10) Search Committee Update

Everist stated that the Search Committee has met with Russell Reynolds by conference call weekly for the last six weeks to receive progress reports on their national search efforts. There are four candidates that the entire Council will be interviewing on July 12 and 13, 2004. It is hoped that the process will be concluded by the end of July at the latest.

11) Compensation Committee Update

Everist stated that compensation issues were discussed in executive session.

12) Audit Committee Update

Ness updated the Council on the Audit Committee's meeting in Pierre with Legislative Audit. One of the issues discussed was security when computers are taken home from the office. The other issue involved the new software Legislative Audit will be using during the audit. Legislative Audit laid out their thoughts on the schedule for the audit which is scheduled to begin on August 16, 2004.

Myers discussed how an audit committee functions. He noted that the audit committee meets independent of the CEO of an organization and then meets with the CEO as well. He asked if it would be helpful for a senior staff person to be involved in audit committee meetings to be responsible for information and details that a board member would have more difficulty with because they are not in the office daily.

Everist stated that staff involvement in audit committee meetings is addressed in Sarbanes Oxley. The issues are that the auditors report to the audit committee and that the process include the audit committee meeting with the auditors independent of any management and then with management separately. This gives all involved the opportunity to speak candidly and freely about any issues of interest or concern.

Otten agreed that her understanding of Sarbanes Oxley calls for separate meetings with audit committee and management/staff. She stated that in previous years she was involved in the meetings with Legislative Audit and the audit committee, but that this year to comply with the Sarbanes Oxley study, the auditors will meet independently with the audit committee and staff.

13) Executive Board Meetings

Burr reviewed the Executive Board meeting that was held on June 2, 2004. He noted that the Executive Board approved the Council's recommendation on the Investment Officer's compensation for fiscal year 2005. He felt it was a very good meeting.

The next meeting with the Executive Board will be on August 2, 2004. The fiscal year 2006 budget request will be presented to them along with a brief performance report.

14) PIMCO - HESP - Update

Doug Hajek gave a report as to the legal and regulatory issues facing PA Distributors, LLC ("PAD"), and other entities affiliated with Allianz Dresdner Asset Management of America, LLC ("ADAM") as a result of certain alleged wrongful activities in the mutual fund market. (PAD, formerly known as PIMCO Advisors Distributors LLC, is the program manager of the South Dakota Higher Education Savings Program.) Hajek also reported on the due diligence activities currently being undertaken by the Council staff and legal counsel to determine whether any of these issues adversely affect the Council and the State's 529 program.

Hajek discussed the April 19, 2004 article from Fortune magazine about Eddie Stern and the unconventional trading activities of Canary Capital Partners, a company founded by Mr. Stern. He also reported on the telephone conference that he, Steve Myers, Tammy Otten and Arianna Juillard had on June 15 with Tim Clark, Julie Jones and Harvey Wolkoff. Ms. Jones and Mr. Wolkoff are partners of Ropes & Gray, which serves as counsel to ADAM, with Mr. Wolkoff being the point person in the regulatory issues ADAM currently faces. During the course of the discussion, Mr. Wolkoff stated that the Fortune article is probably a pretty fair report as to Eddie Stern and his activities. Mr. Wolkoff also stated his view that overall, the people within the ADAM organization have been very responsible, and completely cooperative in addressing these matters.

Background

Hajek gave background of the Stern family, which over time became a very well-known and respected family with, according to Mr. Wolkoff, a certain amount of "celebrity" status. Eddie Stern's role in the family business was to manage the family's money, and in that role he started Canary Capital. Over time, through people he hired, the firm adopted what is known as a "momentum strategy" of investing in mutual funds, which involved an unusually high level of mutual fund trading activity. This kind of activity is strongly discouraged (or prohibited) by most mutual fund managers, but when dealing with Canary Capital, several of the large fund companies, apparently including PAD and other subsidiaries of ADAM, did not follow their own rules.

Hajek stated that the Canary Capital cases involved allegations of one or more of the following activities: (1) market timing, (2) sticky (longer term) assets provided by Canary in exchange for marketing timing capacity with any particular fund distributor, and (3) late trading activity (which was not alleged in the ADAM cases).

Legal and Regulatory Issues

In February, New Jersey started an action against ADAM, PAD, Pacific Investment Management Company LLC ("PIMCO"), and PEA Capital LLC ("PEA Capital"). (PAD, PIMCO, and PEA Capital are all subsidiaries of ADAM.) PIMCO was later dismissed from the case after PIMCO's CEO, Bill Gross, successfully convinced the New Jersey Attorney General and the court that it had done nothing wrong. Although he denied any wrongdoing, Ken Corba, CEO of PEA Capital, resigned over the allegations.

Steve Treadway, CEO of PAD was criticized for acquiescing in the improper activities and for not reporting these irregularities until a year later. Treadway feels he was let down by one of his colleagues and asserts that he stopped the inappropriate activity as soon as he became aware of it.

The ADAM entities settled the New Jersey action on June 1. Payment of \$18 million by ADAM, \$15 million of which was fines and \$3 million of which was to pay New Jersey for expenses. In addition, \$1.6 million in payments were made to shareholder funds for losses that those funds incurred as a result of the criticized activities. Also as a result of settlement, Steven Treadway is not allowed to be in an executive capacity in connection with the Multi-Manager Series to assure that the portfolio managers of such funds operate independently of the distributors of those funds.

Also on June 1, Bill Gross sent out a release that none of the other ADAM entities would any longer carry the PIMCO name. As a result, PIMCO Advisors Distributors LLC has changed its name to PA Distributors LLC.

The SEC started its action on May 6. Named in that action are PEA Capital, PIMCO Equity Advisors LLC ("PEA"), PAD, PIMCO Advisors Fund Management LLC ("PAFM"), Treadway and Corba. PIMCO was not named as a defendant. Hajek reported that, according to Harvey Wolkoff, settlement negotiations were ongoing, but he didn't know how much longer it would take before these issues would be resolved. He mentioned that even though New York Attorney General Elliot Spitzer was the person who was the chief recipient of the information that gave rise to the scandal, it is not expected that the State of New York will bring action against ADAM. Mr. Wolkoff believes the only action left to resolve is the SEC case.

Subsequent Measures

Hajek read to the Council the email that Steve Myers sent to Tim Clark on May 7 which laid out the principal concerns of the Council with respect to the criticized activities and the regulatory action under way. Hajek and Steve Myers reported that the staff has been working hard to confirm that those issues are being appropriately addressed.

Hajek also reported that on May 12, Tim Clark sent a letter to Steve Myers stating, among other things, that PAD is "extremely sensitive to the high standards you have set for all investment managements (sic) firms utilized in the College Access 529 program ..."

Based upon the due diligence work completed thus far, Hajek advised the Council that at this time it is believed that the CollegeAccess 529 Program has suffered no loss as a result of the criticized activities of ADAM affiliates. (According to Harvey Wolkoff, Canary actually incurred a loss overall in every PAD fund Ropes & Gray reviewed, except one which had a gain of about \$900,000, but it is not part of CollegeAccess 529). There is one of the funds (Franklin) the staff is still checking on to make sure that none of these inappropriate activities were going on at the time we were doing the program. Staff is asking for more documentation and confirmation re the Franklin Fund.

Hajek and Steve Myers also reported that the Council staff is making further inquiries of the ADAM organization to insure that Allianz is revising its policies and procedures to conform to the best practices at other reputable organizations. The staff will be making sure it is comfortable with the new standards established by ADAM, and Hajek assured the Council that the staff will be very direct with PAD if they are not satisfied with the steps ADAM takes or has taken in connection with this matter.

Hajek and Myers assured the Council that the staff was determined to have a strong and well-managed 529 program. None of what has occurred changes the program infrastructure even though the program manager has changed its name. The name change has been raised as a concern, however, because the strong reputation of PIMCO was believed to be an important attribute for the overall attractiveness of the program in the market place. Initial discussions have been had with Tim Clark on this subject, but Mr. Clark has expressed his view that eliminating "PIMCO" from the name of the program manager should not adversely affect the South Dakota program. Hajek reported that this remains an open issue, because the staff is not convinced that changing the name will have no adverse affect.

Another concern discussed by Hajek was whether ADAM is committed to standing behind the obligations of PAD. Under the Program Management Agreement, PAD has undertaken a broad indemnification of the state and the Council for any loss or claims arising under the program. Hajek stated that the strength of this indemnification rests largely on the commitment that ADAM has to PAD, because it is with ADAM that all of the financial strength lies. He stated that this is a concern that has been shared with PAD and its legal counsel, and that these concerns are heightened as a result of the recent regulatory and legal problems, and PAD being forced to eliminate PIMCO from its name. These developments raise legitimate issues as to how firmly ADAM is committed to the well-being of PAD, and ADAM's willingness to stand behind the obligations of PAD.

PAD has stressed that PAD is the sole distribution arm of Allianz in the U.S, and as a result, it is critical to the operation of ADAM, even though PAD is not a heavily capitalized organization. PAD has indicated that their net worth was about \$43 million, which is considerably above regulatory requirements, but probably not sufficient to provide a large measure of protection for indemnification purposes. PAD is also aware that the staff is very disturbed that PAD started 2003 with \$86 million in capital, but due to a distribution of \$55 million to its parent, cut its capital in

half by the end of 2003. Hajek assured the Council that this matter would get a good deal more attention so that the Council could be comfortable that ADAM will stand behind the obligations of ADAM.

Following Hajek's presentation, members of the Council had the opportunity to ask questions and discuss their concerns.

Everist referred to the case against Canary Capital and asked how clear it is that they engaged in unlawful activities. Hajek responded that although not necessarily unlawful per se, allowing market timing trading in mutual funds is generally imprudent and potentially costly to other investors in the fund, and a real problem if the fund distributor has an expressed policy against such activity. In PAD's case, it is alleged that the disclosure document stated that such activities are strongly discouraged, yet apparently Canary was allowed to engage in market timing on a large scale. Late trading is an even worse transgression. Some companies allegedly allowed Canary to "place its bets after the horses crossed the finish line." This would clearly be an unlawful activity. Fortunately, there has been no allegation that the ADAM entities were involved in that activity.

Everist asked if it was correct that Ken Corba didn't follow PEA's own rules. Hajek stated that was correct. Corba, however, apparently made special arrangements with Canary to allow market timing before the South Dakota program ever started.

Healy asked if Canary had been charged. Hajek responded that Eddie Stern reportedly paid \$40 million as part of his deal with the New York Attorney General, and apparently will not be prosecuted.

Everist asked how the Council gets satisfied that the standards insisted on by Steve Myers will be followed. Myers suggested that all of the things are followed through by Doug Hajek with staff. We want it all in print. We also want to confirm in writing by PAD and its counsel that there were no losses in CollegeAccess 529 as a result of the criticized activities.

Hajek added that we will be drafting a letter to Ropes & Gray to clearly let them know what we expect them to address and confirm, and further steps they will take to assure that problems of this type do not occur in the future.

Everist referred to the \$55 million that was distributed to PAD's parent and asked if we are still comfortable if Allianz is willing to stand behind PAD. Hajek stated it would be a huge problem if the Council felt that Allianz could drain PAD to effectively avoid its obligations to the Council. These concerns could be addressed in several different ways: (1) they could convince us that we needn't be concerned, that it is inconceivable that ADAM would abandon PAD, (2) we could insist on financial covenants that require PAD to maintain certain levels of capital in excess of what is required for regulatory purposes, or (3) the Council could insist that ADAM agree in writing to stand behind PAD's obligations.

Everist asked why the parent wouldn't acknowledge in writing that they are obligated. Hajek responded that we should first ask ADAM to acknowledge the obligation in writing. If they decline, we will press them as to why --- and we won't give up on that without the blessings of the

Council. Although we should press them for this concession, there are any number of reasons as to why they would not want to do it, none of them with any sinister motive, but this will be a good test of ADAM's commitment to the program.

Burr stated that Allianz is a very upstanding company and that it doesn't seem like they would abandon one of their subsidiaries.

Everist stated that down the line, Allianz could decide to get out of the distributor business, and the Council would be left hanging. He believes we are in a good position to demand because (1) you distributed millions to parent company, and (2) you changed your name, and therefore, the Council wants a letter from Allianz recognizing obligation and pledge support.

Myers stated that would be almost a fallback and that Doug is trying to get a legal commitment first. Doug should brief the Council on other lines of defense.

Hajek stated the Council has a strong case that it is immune from suit, but cannot be absolutely confident of its position. PAD's indemnification is a backup to the sovereign immunity defense, and in addition to its own capital, PAD carries insurance to cover certain claims. The Council could indirectly benefit from this coverage.

Lavin asked if the Council was important enough to Allianz to assume they would save us. Hajek responded that the question is really whether PAD is important enough to save, both as its sole fund distributor, and as program manager of South Dakota's 529 program. If we can get ADAM to legally stand behind PAD's obligations, those concerns can largely be eliminated. If ADAM is not willing to agree in writing, then we will have to deal with that. I know that ADAM, out of general principle alone, will resist signing a document, but I can't say they will refuse.

Myers stated that we have asked for the last five years of financial statements for the practice of PAD dividends to parent. He added that he is less concerned today than he was at the end of that telephone call.

Hajek stated that on May 15, the office received a call from the SEC, compliance division. Matt and Arianna had an opportunity to talk to the SEC.

In reviewing the call from the SEC, Clark stated that the SEC wanted to understand the nature of our arrangements with PAD. They had questions on fees and the scholarships PIMCO provides. They seemed to be on a fishing expedition. We tried to lessen their concerns with facts that were readily available. Clark thought their concerns were alleviated. They asked to see our program management agreement, investment policies and information regarding our process of selecting PIMCO. Clark indicated to them that he thought we would be able to provide them with the requested information. However, he told them he was not an attorney, and he was uncertain as to the existence of any legal constrictions and wanted to first run it by Doug Hajek, our attorney for the 529 program. Clark also indicated to the SEC that if they had any further questions, to feel free to give us a call. Immediately after the call, Clark called Hajek and sent a message to Steve Myers. Myers and Hajek talked and Myers' opinion was to send it off right away. Hajek then called the

SEC and left a message that we would send the requested documents. The information was sent to the SEC that afternoon.

Hajek stated that the staffs instincts were very good. It was an opportunity to show the SEC that we want to be fully cooperative. It is important to note, however, that our program management agreement does not directly give us the right to speak to regulators about the program without the permission of PAD. Hajek added that he has spoken to Ropes & Gray, and they completely agreed with staff answering the SEC's questions, and in our expressing that we would cooperate with them if they needed any further information. If we should receive any further calls from the SEC, we will express our desire to cooperate and then immediately confer with Ropes & Gray.

Hajek stated that as it turns out, we believe the SEC call related to a survey it was conducting in connection with an upcoming hearing regarding possible regulation and uniform disclosure of 529 programs.

Johnson stated that he felt everything was being done correctly. He added that his concern is that all of the money is in good hands, in a safe situation.

Higher Education Savings Plan Update

Arianna Juillard distributed an updated summary on the PIMCO SD Scholarship program. In addition to the 70 \$8,000 renewable scholarships that have been awarded, an additional 221 oneyear \$1,500 scholarships were awarded last week. The summary included information on college distribution and top majors. The median ACT score for all applicants was 28.96 with an average GPA of 3.88. For just the top 70 recipients the average ACT score was 31.47 with an average ACT of 3.95. The applicants were also broken down by high schools and cities across the state.

Juillard stated that as of June 15, 2004, there was a little over \$270 million in total in the HESP, which included Legg Mason and approximately \$13 million in South Dakota. She noted that this is the last year that the contract guarantees awarding 70 scholarships. To award scholarships in addition to the current commitments, assets would have to be over \$420 million. She added that money has been used out of the marketing budget to pay the additional scholarships. Another option for funding is that any excess marketing budget at the end of the year is pulled and put into a supplemental scholarship budget. This supplemental budget should total about \$230,000 by the end of the year. Juillard added that her calculations show we are on track to reach the \$420 million in the next year.

Myers stated that the Council has a seven-year contract with PIMCO, so at some point in time the Council needs to decide whether they want to re-negotiate. There is a one year window in the contract where the Council can talk to other fund managers.

15) Election of Officers

BRYCE HEALY NOMINATED ROY BURR AS CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2005. LARRY NESS SECONDED THE NOMINATION. NOMINATION PASSED UNANIMOUSLY.

ROY BURR NOMINATED TOM EVERIST AS VICE CHAIR OF THE INVESTMENT COUNCIL FOR FISCAL YEAR 2005. ANGELINE LAVIN SECONDED THE NOMINATION. NOMINATION PASSED UNANIMOUSLY.

16) Future Meeting Dates

After Council discussion, the April, 2005 meeting date was changed to April 30, 2005 to coincide with the Berkshire Hathaway annual meeting in Omaha. The June 22/23, 2005, meeting will be held in Rapid City.

17) New/Old Business

Healy suggested that Steve Myers compile his memoirs from the last 30 years. He felt it would be important for the Investment Council to have Steve's perspective on important historical events that have occurred since the inception of the Investment Office. This could include the beginning, the ups and downs, interactions with legislative issues, etc.

Chair Burr declared the meeting adjourned.